



But What About the Motive? Section 183 and the Doctors' Child  
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## Profit Motive Issues

This week the podcast looks at a case involving a pair of doctors and the education they provided in their home, with state assistance, to their autistic child who run afoul of the profit motive requirements in §183.

Generally, if an activity is not engaged in with a proper profit motive, then the deductions are limited by §183. We start out with the general rule that denies a deduction for activities not engaged in for a profit, except as provided under this section:

### SEC. 183. ACTIVITIES NOT ENGAGED IN FOR PROFIT.

(a) GENERAL RULE. --In the case of an activity engaged in by an individual or an S corporation, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.

The deductions allowed are found in the following subsection:

SEC. 183(b) DEDUCTIONS ALLOWABLE. -- In the case of an activity not engaged in for profit to which subsection (a) applies, there shall be allowed --

(1) the deductions which would be allowable under this chapter for the taxable year without regard to whether or not such activity is engaged in for profit, and

(2) a deduction equal to the amount of the deductions which would be allowable under this chapter for the taxable year only if such activity were engaged in for profit, but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1).

The deduction is limited to the amount of income from the activity by this provision—but it's somewhat worse. If you look in §62, you'll find that deductions allowed under §183 are not allowed in computing adjusted gross income. As well, it's not listed as an itemized deduction not subject to the 2% of adjusted gross income limitation in §67(b). What that means is that not only are deductions subject to being limited to the income derived, they are also subject to the 2% limitation and would not be deductible for purposes of computing the alternative minimum tax.

(c) **ACTIVITY NOT ENGAGED IN FOR PROFIT DEFINED.** --For purposes of this section, the term "activity not engaged in for profit" means any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212.

What this represents is effectively a circular definition, since both Section 162 and 212 require a profit motive for the transaction. So if you aren't under Section 162 and 212 because you lack a profit motive, you lack a profit motive.

(d) **PRESUMPTION.** --If the gross income derived from an activity for 3 or more of the taxable years in the period of 5 consecutive taxable years which ends with the taxable year exceeds the deductions attributable to such activity (determined without regard to whether or not such activity is engaged in for profit), then, unless the Secretary establishes to the contrary, such activity shall be presumed for purposes of this chapter for such taxable year to be an activity engaged in for profit. In the case of an activity which consists in major part of the breeding, training, showing, or racing of horses, the preceding sentence shall be applied by substituting "2" for "3" and "7" for "5".

This may be one of the most misunderstood portions of this section—the law doesn't say either that you *have* to show a profit in 3 of 5 years (or 2 of 7 for horse activities) or you subject to the limitations under §183, nor that if you do have the profit that you automatically get out of §183's application.

(e) **SPECIAL RULE.** --

(1) **IN GENERAL.** --A determination as to whether the presumption provided by subsection (d) applies with respect to any activity shall, if the taxpayer so elects, not be made before the close of the fourth taxable year (sixth taxable year, in the case of an activity described in the last sentence of such subsection) following the taxable year in which the taxpayer first engages in the activity. For purposes of the preceding sentence, a taxpayer shall be treated as not having engaged in an activity

during any taxable year beginning before January 1, 1970.

(2) INITIAL PERIOD. --If the taxpayer makes an election under paragraph (1), the presumption provided by subsection (d) shall apply to each taxable year in the 5-taxable year (or 7-taxable year) period beginning with the taxable year in which the taxpayer first engages in the activity, if the gross income derived from the activity for 3 (or 2 if applicable) or more of the taxable years in such period exceeds the deductions attributable to the activity (determined without regard to whether or not the activity is engaged in for profit).

(3) ELECTION. --An election under paragraph (1) shall be made at such time and manner, and subject to such terms and conditions, as the Secretary may prescribe.

(4) TIME FOR ASSESSING DEFICIENCY ATTRIBUTABLE TO ACTIVITY. --If a taxpayer makes an election under paragraph (1) with respect to an activity, the statutory period for the assessment of any deficiency attributable to such activity shall not expire before the expiration of 2 years after the date prescribed by law (determined without extensions) for filing the return of tax under chapter 1 for the last taxable year in the period of 5 taxable years (or 7 taxable years) to which the election relates. Such deficiency may be assessed notwithstanding the provisions of any law or rule of law which would otherwise prevent such an assessment.

Finally, we have the election to extend the statute in order to meet the presumptive test. You can extend the statute to see if you will meet the test, but the statute is held open until two years after the final return is filed.

## The Tests Under the Regulation §1.183-2(b)

The IRS in Regulation §1.183-2(b) lists out nine factors to be considered to determine if any activity is not engaged in for a profit:

(1) *Manner in which the taxpayer carries on the activity.* --The fact that the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books and records may indicate that the activity is engaged in for profit. Similarly, where an activity is carried on in a manner substantially similar to other activities of the same nature which are profitable, a profit motive may be indicated. A change of operating methods, adoption of new techniques or abandonment of unprofitable methods in a manner consistent with an intent to improve profitability may also indicate a profit motive.

(2) *The expertise of the taxpayer or his advisors.* --Preparation for the activity by extensive study of its accepted business, economic, and scientific practices, or consultation with those who are expert therein, may indicate that the taxpayer has a profit motive where the taxpayer carries on the activity in accordance with such practices. Where a taxpayer has such preparation or procures such expert advice,

but does not carry on the activity in accordance with such practices, a lack of intent to derive profit may be indicated unless it appears that the taxpayer is attempting to develop new or superior techniques which may result in profits from the activity.

(3) *The time and effort expended by the taxpayer in carrying on the activity.* --The fact that the taxpayer devotes much of his personal time and effort to carrying on an activity, particularly if the activity does not have substantial personal or recreational aspects, may indicate an intention to derive a profit. A taxpayer's withdrawal from another occupation to devote most of his energies to the activity may also be evidence that the activity is engaged in for profit. The fact that the taxpayer devotes a limited amount of time to an activity does not necessarily indicate a lack of profit motive where the taxpayer employs competent and qualified persons to carry on such activity.

(4) *Expectation that assets used in activity may appreciate in value.* --The term "profit" encompasses appreciation in the value of assets, such as land, used in the activity. Thus, the taxpayer may intend to derive a profit from the operation of the activity, and may also intend that, even if no profit from current operations is derived, an overall profit will result when appreciation in the value of land used in the activity is realized since income from the activity together with the appreciation of land will exceed expenses of operation. See, however, paragraph (d) of §1.183-1 for definition of an activity in this connection.

(5) *The success of the taxpayer in carrying on other similar or dissimilar activities.* --The fact that the taxpayer has engaged in similar activities in the past and converted them from unprofitable to profitable enterprises may indicate that he is engaged in the present activity for profit, even though the activity is presently unprofitable.

(6) *The taxpayer's history of income or losses with respect to the activity.* --A series of losses during the initial or start-up stage of an activity may not necessarily be an indication that the activity is not engaged in for profit. However, where losses continue to be sustained beyond the period which customarily is necessary to bring the operation to profitable status such continued losses, if not explainable, as due to customary business risks or reverses, may be indicative that the activity is not being engaged in for profit. If losses are sustained because of unforeseen or fortuitous circumstances which are beyond the control of the taxpayer, such as drought, disease, fire, theft, weather damages, other involuntary conversions, or depressed market conditions, such losses would not be an indication that the activity is not engaged in for profit. A series of years in which net income was realized would of course be strong evidence that the activity is engaged in for profit.

(7) *The amount of occasional profits, if any, which are earned.* --The amount of profits in relation to the amount of losses incurred, and in relation to the amount of

the taxpayer's investment and the value of the assets used in the activity, may provide useful criteria in determining the taxpayer's intent. An occasional small profit from an activity generating large losses, or from an activity in which the taxpayer has made a large investment, would not generally be determinative that the activity is engaged in for profit. However, substantial profit, though only occasional, would generally be indicative that an activity is engaged in for profit, where the investment or losses are comparatively small. Moreover, an opportunity to earn a substantial ultimate profit in a highly speculative venture is ordinarily sufficient to indicate that the activity is engaged in for profit even though losses or only occasional small profits are actually generated.

(8) *The financial status of the taxpayer.* --The fact that the taxpayer does not have substantial income or capital from sources other than the activity may indicate that an activity is engaged in for profit. Substantial income from sources other than the activity (particularly if the losses from the activity generate substantial tax benefits) may indicate that the activity is not engaged in for profit especially if there are personal or recreational elements involved.

(9) *Elements of personal pleasure or recreation.* --The presence of personal motives in carrying on of an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved. On the other hand, a profit motivation may be indicated where an activity lacks any appeal other than profit. It is not, however, necessary that an activity be engaged in with the exclusive intention of deriving a profit or with the intention of maximizing profits. For example, the availability of other investments which would yield a higher return, or which would be more likely to be profitable, is not evidence that an activity is not engaged in for profit. An activity will not be treated as not engaged in for profit merely because the taxpayer has purposes or motivations other than solely to make a profit. Also, the fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as not engaged in for profit if the activity is in fact engaged in for profit as evidenced by other factors whether or not listed in this paragraph.

Note that this is a “facts and circumstances” test, which means it cannot be mechanically applied. If, as will be true in most cases, some factors break for the taxpayer and some against, it will, in the end, a “smell” test that can vary—so sometimes it’s tough to reconcile cases.

However, a recent case illustrates that taxpayers will end up in court even when it doesn’t appear that there’s a very convincing case for a profit motive.

## The Case of the Doctors’ Child

In the case of *Michael Paul Remler and Pauline M. Velez* ([T.C. Memo. 2005-265](#)), the Tax

Court was dealing with a pair of physicians who had a child that was diagnosed with moderately severe autism in 1997. Eventually, the taxpayers decided that the Berkeley schools could not provide their child with the education needed, and entered into an agreement with the school district to reimburse them \$44,000 each year for providing the education in exchange for the parents agreeing not to hold the district liable for not providing a free education.

The taxpayers set up a “microschool” and “afterschool” program with the funds from the district and funding from an organization called “Regional Center” for parents with children with learning disabilities. The expenses for the education exceeded the income each year.

The doctors’ child was the only participant in either program, and the doctors did not advertise or otherwise seek out other participants for their program. They did not apply for any other grant funds, did not maintain a bank account or have any separate assets dedicated to this matter.

The court went through the nine factors noted above in coming to the conclusion that there was not a profit motive. While the court found that Dr. Remler had special expertise in this area, it went on to note:

This factor is heavily outweighed by the manner in which petitioners conducted the activity, the time and effort they expended, the lack of occasional profits, petitioners' financial status, and their personal motive. We hold that petitioners did not engage in the special education activity for profit during the years in issue within the meaning of section 183.

In this case, the smell clearly was a major factor that made this case a very tough sell on the profit motive. What’s more interesting is that the IRS did not assert penalties on this understatement, but rather assessed that only on the failure to report a state income tax refund.